

USING TRUSTS TO HAND DOWN RETIREMENT ASSETS: Protect the Value of Your Retirement Assets for the Next Generation

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Deciding who to name as the beneficiary of retirement accounts is not always a simple process, but it's very important to creating a sound estate plan. For many people, retirement accounts comprise a substantial part of their net worth because the retirement accounts have been funded to the maximum extent possible to take advantage of the tax deferral benefits. What is the best way to pass down the retirement plans to which you have so diligently contributed over the years so that the account assets are protected from your heirs' creditors and spouses while also taking advantage of the ability to postpone the income taxes due on the retirement accounts? Typically, the best option is a trust that is designed to achieve all of these goals.

It has been our experience that the vast majority of people name their spouse, then their children (if the spouse does not survive), as the beneficiaries of their retirement plans. In most cases, naming the spouse as the primary beneficiary continues to be the best option. However, if you have named your children, individually, as beneficiaries of your retirement plans, you may be missing the opportunity to ensure the retirement accounts are as protected as possible. Instead, naming a properly drafted trust that benefits your child as the beneficiary of the retirement accounts supplies the retirement benefits with the general protections inherent to trusts—such as protection from your child's creditors, protection from the claims of the child's spouse during a divorce proceeding, and avoidance of estate tax.

While Texas law specifically exempts "inherited" individual retirement accounts from the reach of creditors, whether or not the debtor is in bankruptcy, inherited retirement accounts are not exempt from creditor's claims in most states. Therefore, naming a child, individually, as a beneficiary of a retirement plan requires an all-in bet that the child will always be a resident of Texas or another state that protects inherited retirement accounts. Naming a qualifying trust as a beneficiary, however, reduces the need to worry about what state your children will live in.

Although it has not always been popular to name a trust as the beneficiary of retirement accounts for income tax reasons, it is now possible to utilize a trust that contains specific IRS-approved provisions to take advantage of "stretch-out." Stretch-out allows the person inheriting the retirement account to choose to receive distributions from the retirement account over his or her actuarial life expectancy, rather than through an accelerated payout. If a trust is named as the beneficiary of the retirement accounts, and the trust does not contain the specific IRS-approved language, the trust must typically withdraw the assets from the retirement accounts over a five-year period. This results in the trust paying all of the deferred income taxes due on the retirement accounts within five years instead of the full life expectancy of the trust beneficiary. In most instances, it is preferable to take advantage of stretch-out because it maximizes the deferral of the income taxes associated with the retirement accounts.

Note that if you intend to leave a portion of your assets to charity at your death, you should consider naming the charity as the beneficiary of a portion of your retirement accounts in order to satisfy the gift. Retirement account assets could be hit with both a 39.6% income tax and a 40% estate tax at your death, leaving just a fraction of the retirement assets to the named beneficiary (perhaps as

little as 20 cents on the dollar). However, when you name a charity as the beneficiary of a retirement account, you avoid both the estate tax and income tax liability associated with the assets, and the charity will receive the full 100 cents of each dollar. When you review your estate plan and beneficiary designations, remember the tax advantages of naming a charity as the beneficiary of some or all of your retirement accounts, and instead consider leaving other estate assets to your heirs.

Although many people believe it is easier to simply name a child, individually, as a beneficiary of a retirement account, naming a properly drafted trust that benefits the child is the most effective way to ensure the retirement funds actually end up in the hands of the beneficiary while still achieving the maximum income tax deferral. Leaving the retirement account to a specially drafted qualifying trust eliminates many of the questions and what-ifs that plague clients: What if my child gets divorced? What if my child gets sued? What if my child is not financially responsible enough to manage the benefits? What if my child moves out of Texas and loses bankruptcy protection? These questions are common, and they can all be soundly addressed by naming a qualifying trust as the beneficiary of the retirement accounts.

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